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## Treatment of Cash Distributions to Shareholders Pursuant to a Corporate Reorganization: Shimberg v. United States

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**Treatment of Cash Distributions to Shareholders Pursuant to a Corporate Reorganization: *Shimberg v. United States***<sup>1</sup>—Taxpayer, Mandel Shimberg, Jr., was president and majority shareholder<sup>2</sup> of La Monte-Shimberg Corporation [LSC].<sup>3</sup> In September 1970, LSC executed a Plan and Agreement of Merger [Agreement] with MGIC Investment Corporation [MGIC].<sup>4</sup> Under the terms of the Agreement, LSC was to be acquired by MGIC in a statutory merger which qualified as a reorganization under Internal Revenue Code section 368(a)(1)(A).<sup>5</sup> In December 1970, the merger was consummated, with LSC shareholders receiving a pro rata distribution of \$625,000 cash, 32,132 shares of MGIC common stock outright, and the same number of shares in escrow.<sup>6</sup> The taxpayer's share of this distribution amounted to 24,461 shares of MGIC common stock, a like number of shares in escrow, and a cash "boot"<sup>7</sup> of \$417,449. Prior to the reorganization, LSC had undistributed earnings and profits of approximately \$725,000.<sup>8</sup>

On his 1970 federal income tax return, Mr. Shimberg reported the cash received in connection with the merger as a long term capital gain from the sale of a capital asset.<sup>9</sup> The Commissioner of Internal Revenue determined that the cash distribution constituted a dividend under section 356(a)(2),<sup>10</sup>

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<sup>1</sup> 577 F.2d 283 (5th Cir. 1978), *cert. denied*, \_\_\_ U.S. \_\_\_, 99 S. Ct. 1019 (1979).

<sup>2</sup> Prior to the reorganization, Mr. Shimberg owned (directly or indirectly) 66.8% of LSC capital stock. *Id.* at 284.

<sup>3</sup> LSC was a closely held Florida corporation engaged in home construction and sales. *Id.*

<sup>4</sup> *Id.* at 285. MGIC is a publicly held Delaware corporation. *Id.*

<sup>5</sup> I.R.C. § 368(a)(1)(A). The parties stipulated that the merger was an "A" reorganization and that if the cash did not have "the effect of a distribution of a dividend" within the meaning of § 356(a)(2), the LSC shareholders would be entitled to capital gains treatment. Brief for Plaintiff at 5, *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978). The word "reorganization" has a technical meaning for Federal income tax purposes. Section 1.368-2(a) of the Treasury regulations restricts the use of the term to those transactions which fall within one of the six categories found in § 368. The letter of the subheading is used as a prefix to identify the form of the corporate adjustment.

<sup>6</sup> 577 F.2d at 285. The shares in escrow were to be delivered in five years upon the satisfaction of an earnings requirement based upon an average of the earnings of LSC for the years 1970 through 1974. Brief for Plaintiff at 5, *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978).

<sup>7</sup> Property received in addition to stock is commonly known as "boot."

<sup>8</sup> 577 F.2d at 288.

<sup>9</sup> *Id.*

<sup>10</sup> I.R.C. § 356(a) provides:

SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION.

(a) *Gain on Exchanges*—

(1) *Recognition of gain.* If

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an

taxable as ordinary income.<sup>11</sup> The taxpayer paid the resulting deficiency and subsequently filed for a refund.<sup>12</sup> Upon the Commissioner's disallowance of his refund claim, Mr. Shimberg commenced suit in federal district court.<sup>13</sup>

The United States District Court for the Middle District of Florida held that the cash received by the taxpayer in connection with the merger did not have "the effect of the distribution of a dividend" within the meaning of section 356(a)(2), and therefore was taxable as a capital gain.<sup>14</sup> The court stated that whether the boot distribution would be entitled to dividend or capital gains treatment depended upon an examination of the total transaction and its effect on the taxpayer's interest as a shareholder.<sup>15</sup> In reaching its decision, the court compared the taxpayer's pre-merger interest of 68 percent in LSC with his post-merger interest of less than 1 percent in MGIC.<sup>16</sup> Since the transaction resulted in a meaningful reduction in the taxpayer's interest as a shareholder, the district court held that the distribution of boot did not have the effect of a dividend, but rather was taxable as a capital gain.<sup>17</sup>

The United States Court of Appeals for the Fifth Circuit reversed the decision of the district court and HELD: A pro rata distribution of cash to a shareholder made pursuant to a merger of a closely held corporation with a large publicly held corporation will be restructured as a dividend distribution made by the acquired corporation prior to reorganization.<sup>18</sup> In so holding, the court rejected the district court's use of "meaningful reduction" analysis in determining whether the distribution of boot has the effect of a dividend under section 356(a)(2).<sup>19</sup> The *Shimberg* court noted that a contrary holding

amount not in excess of the sum of such money and the fair market value of such other property.

(2) *Treatment as dividend.* If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

<sup>11</sup> The term "dividend" can be defined generally as any distribution of property made by a corporation out of earnings and profits which effects no change in basic relationships between the shareholder and either the corporation or the other shareholders.

<sup>12</sup> 577 F.2d at 285. The IRS assessed the taxpayer \$125,883 plus interest of \$16,169.93. *Id.*

<sup>13</sup> *Shimberg v. United States*, 415 F. Supp. 832 (M.D. Fla. 1976). The taxpayer commenced suit in the United States District Court for the Middle District of Florida under 28 U.S.C. § 1346(a)(1) (1976). Brief for Plaintiff at 5, *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978).

<sup>14</sup> 415 F. Supp. at 832.

<sup>15</sup> *Id.* at 836.

<sup>16</sup> *Id.* After the merger the plaintiff controlled less than 1 percent of the MGIC common stock. *Id.*

<sup>17</sup> *Id.* at 837.

<sup>18</sup> 577 F.2d at 289-90.

<sup>19</sup> *Id.* at 288.

would render section 356(a)(2) virtually meaningless since a small corporation's shareholders would always experience a marked reduction in control where a larger corporation merges with a smaller one, unless the same shareholders control both corporations.<sup>20</sup> Thus, the court emphasized that the appropriate focus was not on the reduction in the shareholders' control of the corporation which occurred as a result of the merger.<sup>21</sup> Instead, the Fifth Circuit concluded that section 356(a)(2) requires a focus on whether the distribution would have been taxed as a dividend if made prior to the merger.<sup>22</sup> Accordingly, the court restructured the transaction as if LSC had made a hypothetical distribution of cash prior to the merger.<sup>23</sup> Since LSC had retained earnings of \$725,000 prior to the merger, the court held that the receipt of \$625,000 boot by the former LSC shareholders was a dividend taxable as ordinary income under section 356(a)(2).<sup>24</sup>

The *Shimberg* court's holding—that the determination of dividend effect under section 356(a)(2) requires an examination of the boot distribution as if it had been made by the acquired corporation prior to the reorganization—is significant for two reasons. First, the Fifth Circuit's rejection of the meaningful reduction test strongly indicates that a pro rata distribution of boot received in connection with a merger will always have the effect of a distribution of a dividend when the acquired corporation has sufficient earnings and profits. Second, while *Shimberg* embraces basically the position of the Service as enunciated in Revenue Ruling 75-83,<sup>25</sup> the decision is inconsistent with the approach adopted by the Eighth Circuit in *Wright v. United States*.<sup>26</sup> As a result, the decision adds additional confusion to an already uncertain area in the tax law.

This casenote will first review prior cases involving distributions of boot to corporate shareholders, focusing in particular on the Eighth Circuit's decision in *Wright*.<sup>27</sup> In this light, the casenote will then analyze and evaluate the *Shimberg* decision. Particular attention will be given to the applicability of section 302<sup>28</sup> redemption principles in determining whether a boot distribution

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<sup>20</sup> *Id.*

<sup>21</sup> *Id.* at 290.

<sup>22</sup> *Id.* at 288.

<sup>23</sup> *Id.* at 290.

<sup>24</sup> *Id.* at 289-90.

<sup>25</sup> 1975-1 C.B. 112.

<sup>26</sup> 482 F.2d 600 (8th Cir. 1973).

<sup>27</sup> *Id.*

<sup>28</sup> I.R.C. § 302 provides in relevant part:

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) *General Rule*—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges*—

(1) *Redemptions not equivalent to dividends*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

has the effect of a distribution of a dividend under section 356(a)(2). It will be submitted that the *Shimberg* court has failed to justify its holding that the use of meaningful reduction analysis is inappropriate and that dividend effect under section 356(a)(2) should be measured by reference to the acquired corporation.<sup>29</sup> It will also be suggested that Congress amend section 356(a)(2) and clarify how section 302 standards should be applied in the context of a corporate reorganization.

### I. LEGAL BACKGROUND

This section will initially examine the statutory framework of the section 368(a)(1)(A)<sup>30</sup> reorganization utilized in *Shimberg*, and will then trace the development of the so-called "automatic dividend" rule. Specifically, the section will examine the shift away from the automatic approach to the taxation of boot distributions to the approach adopted by the Eighth Circuit in *Wright v. United States*, whereby section 302 principles are used to determine dividend effect under section 356. Finally, the section will examine Revenue Ruling 75-83, announcing the Service's refusal to follow the *Wright* decision.

Under section 368(a)(1)(A), if a merger or consolidation is effected in compliance with state corporate law,<sup>31</sup> as was the merger in *Shimberg*, no gain or loss will be recognized if a corporation exchanges property for stock and

(2) *Substantially disproportionate redemption of stock—*

(A) *In general—*Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) *Limitation—*This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) *Definitions—*For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time. For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholders ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determination shall be made by reference to fair market value.

<sup>29</sup> 577 F.2d at 289 n.15.

<sup>30</sup> I.R.C. § 368(a)(1)(A).

<sup>31</sup> See DEL. CODE ANN., tit. 8, § 252 (Supp. 1977); FLA. STAT. ANN. § 607.234 (West 1977).

securities in another corporation which is a party to the reorganization.<sup>32</sup> Such mergers or consolidations are commonly referred to as "A" reorganizations. Generally, state statutes allow shareholders to receive property other than stock or securities as consideration for the reorganization.<sup>33</sup> Section 356 provides that where other property (boot) is received in such an exchange, the gain is to be recognized in an amount not in excess of the value of the property received.<sup>34</sup> The issue then becomes whether the receipt of boot is taxable as a dividend or as a long-term capital gain. If the exchange "has the effect of the distribution of a dividend," section 356(a)(2) provides that the gain will be treated as a dividend.<sup>35</sup> If the boot does not have dividend effect, it will be treated as a capital gain.<sup>36</sup>

Until recently the government has adhered to an automatic dividend rule under which all boot is taxed as a dividend to the extent of the taxpayer's pro rata share of earnings and profits.<sup>37</sup> This interpretation was based in large part on imprecise language in the Supreme Court's decision in *Commissioner v. Estate of Bedford*.<sup>38</sup> *Bedford* involved a cash distribution to shareholders made in connection with a recapitalization.<sup>39</sup> The Court stated in dicta that a distribution of earnings and profits pursuant to a reorganization had the effect of a distribution of a taxable dividend.<sup>40</sup> Following this decision, the Commissioner took the much criticized position<sup>41</sup> that any property distribution made in connection with a corporate reorganization would automatically be taxable as dividend income to the extent of earnings and profits.<sup>42</sup>

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<sup>32</sup> I.R.C. § 354.

<sup>33</sup> See note 31 *supra*.

<sup>34</sup> I.R.C. § 356(a).

<sup>35</sup> I.R.C. § 356(a)(2).

<sup>36</sup> *Id.*

<sup>37</sup> See Rev. Rul. 56-220, 1956-1 C.B. 191, in which the Commissioner took the position that whenever there are sufficient accumulated earnings and profits, boot is to be taxed as a dividend. The government appeared to abandon the automatic dividend rule in Rev. Rul. 74-515, 1974-2 C.B. 118, and Rev. Rul. 74-516, 1974-2 C.B. 121. The Commissioner took the position that "[a]lthough section 302 does not literally apply in determining whether a distribution has the effect of a dividend under section 356(a)(2), in appropriate cases the tests contained in that section may serve as useful guidelines for purposes of applying section 356(a)(2)." *Id.* Finally, in Rev. Rul. 75-83, 1975-1 C.B. 112, the Commissioner reconfirmed his position that in determining whether boot has the effect of a distribution of a dividend "it is appropriate to look to principles developed under section 302 for determining dividend equivalency." *Id.*

<sup>38</sup> 325 U.S. 283 (1945). The Court stated "that a distribution pursuant to a reorganization of earnings and profits 'has the effect of a distribution of a dividend' within the meaning of [section 356(a)(2)]." See also B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 14.34 (2d ed. 1971) [hereinafter cited as BITTKER & EUSTICE].

<sup>39</sup> 325 U.S. at 283.

<sup>40</sup> *Id.* at 292.

<sup>41</sup> See, e.g., Levin, Adess and McGaffey, *Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency*, 30 TAX LAW. 287 (1977) [hereinafter cited as Levin]; Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 TAX L. REV. 573 (1965).

<sup>42</sup> See note 37 *supra*.

As the commentators correctly noted, the automatic dividend approach is simply not reconcilable with the language of section 356(a)(2).<sup>43</sup> It is clear that Congress used the phrase "has the effect of the distribution of a dividend" in section 356(a)(2) precisely to avoid the automatic dividend approach expressly adopted in section 356(b)<sup>44</sup> and 356(e).<sup>45</sup> Furthermore, it is a long step from *Bedford*, which involved a recapitalization, to the application of such a rule in acquisitive reorganizations.<sup>46</sup>

In 1958, the Court of Claims in *Idaho Power Co. v. United States*<sup>47</sup> rejected this automatic dividend approach. The case involved a public utility which called its 6 and 7 percent preferred stock by offering shareholders a choice of either 4 percent preferred stock and cash, or cash plus payment of the accrued dividends on the outstanding preferred stock.<sup>48</sup> The Idaho Power Company, in order to obtain favorable tax treatment under the 1939 Code,<sup>49</sup> claimed that the distribution of boot had the effect of a distribution of a dividend. The court disagreed, holding that due to the drastic reduction in the interests of the shareholders, the transaction did not constitute a dividend for the purposes of section 356(a)(2).<sup>50</sup> In so doing, the court rejected the taxpayer's argument that the presence of sufficient earnings and profits *ipso facto* requires dividend taxation.<sup>51</sup>

As a result of the Court of Claim's decision in *Idaho Power*, courts have refused to adopt the automatic dividend approach to determining dividend effect under section 356(a)(2), and have chosen to examine the facts and circumstances of each case.<sup>52</sup> In making this inquiry, courts have considered such factors as whether the distribution was made on a pro rata basis, and whether there was a resulting reduction in the taxpayer's equity interest in the continuing corporation.<sup>53</sup> Despite the rejection of the automatic dividend rule, cases decided after *Idaho Power* have done little to clarify the question

<sup>43</sup> J. SCOTT, JR., FEDERAL INCOME TAXATION OF CORPORATE REORGANIZATIONS 49 (Practising Law Institute, 1972) [hereinafter cited as SCOTT].

<sup>44</sup> I.R.C. § 356(b). This section is applicable when boot is received in connection with a divisive reorganization.

<sup>45</sup> I.R.C. § 356(e). This section is applicable when boot is received in exchange for § 306 stock.

<sup>46</sup> See BITTKER & EUSTICE, *supra* note 38. There is no acquiring corporation in a recapitalization as the transaction is merely a readjustment in the financial structure of a single corporation. *Id.* at § 14.59.

<sup>47</sup> 161 F. Supp. 807 (Ct. Cl.), *cert. denied*, 358 U.S. 832 (1958).

<sup>48</sup> *Id.* at 808.

<sup>49</sup> See Int. Rev. Code of 1939, § 26(h) (now I.R.C. § 247). This section allows public utility companies to deduct a portion of dividends paid on certain preferred stock. This is an exception to the general rule that dividends paid by a corporation are not deductible.

<sup>50</sup> 161 F. Supp. at 810.

<sup>51</sup> *Id.* at 809.

<sup>52</sup> *E.g.*, *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973); *Hawkinson v. Commissioner*, 235 F.2d 741 (2d Cir. 1956); *Ross v. United States*, 173 F. Supp. 793 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959).

<sup>53</sup> See cases cited in note 52 *supra*.

whether a boot distribution has the effect of a dividend. In any given transaction the issue remains whether dividend or capital gain characteristics predominate.

Section 356 is not the only Code section in which the issue of dividend effect arises. In adopting section 356(a)(2) Congress virtually paraphrased section 302(b)(1), which provides that if a corporation redeems its stock and the "redemption is not essentially equivalent to a dividend," the transaction will be entitled to capital gains treatment. Section 302 provides two standards under which a redemption of stock may qualify for capital gains treatment. Section 302(b)(1), as noted, affords capital gains treatment to stock redemptions which are not "essentially equivalent to a dividend." A taxpayer may also qualify for preferred tax treatment if he can satisfy the disproportionate redemption and termination of interest requirements of section 302(b)(2). These percentage requirements—the so-called safe harbor provisions—are met if:

- (1) the shareholder owns less than 50 percent of the total stock after the redemption; and
- (2) the ratio of voting stock owned after the redemption is less than 80 percent of the percentage of voting stock owned before the redemption; and
- (3) the ratio of common stock (whether voting or non-voting) after the redemption is less than 80 percent of the percentage owned before the redemption.

Despite the absence of an express statutory relationship between sections 302 and 356, courts have often applied the principles developed under section 302 in deciding cases under section 356(a)(2).<sup>54</sup>

Prior to 1970 and the Supreme Court's decision in *United States v. Davis*,<sup>55</sup> the standards for determining dividend equivalence under section 302(b)(1) were not well defined.<sup>56</sup> In *Davis*, the Supreme Court adopted a test for determining dividend equivalence under section 302(b)(1).<sup>57</sup> The Court was faced with a redemption of preferred stock by a corporation which issued the shares to obtain working capital in order to negotiate a loan.<sup>58</sup> The Court held that to avoid dividend equivalency the redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation.<sup>59</sup> The taxpayer did not meet this test since he was the sole shareholder of the corporation before and after the redemption.<sup>60</sup> The Court also noted that in making a determination whether a payment in redemption of stock was "essentially equivalent to a dividend," business purpose

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<sup>54</sup> *Id.*

<sup>55</sup> 397 U.S. 301 (1970).

<sup>56</sup> See Zinn & Silverman, *Redemptions of Stock under Section 302(b)(1)*, 32 *Tax Law* 91-92 (1979).

<sup>57</sup> 397 U.S. at 313.

<sup>58</sup> *Id.* at 303.

<sup>59</sup> *Id.* at 313. The taxpayer owned all preferred and 25 percent of the common stock. His wife and two children held the remaining stock. *Id.* at 302.

<sup>60</sup> *Id.* at 313.



and motive are irrelevant.<sup>61</sup> Thus, after *Davis*, to qualify for exchange treatment under section 302(b)(1) a stock redemption "must result in a meaningful reduction of the shareholder's proportionate interest in the corporation."<sup>62</sup>

The first circuit court to consider the applicability of the meaningful reduction test developed in *Davis* to a section 356 boot distribution was the United States Court of Appeals for the Eighth Circuit in *Wright v. United States*.<sup>63</sup> *Wright* involved the merger of two affiliated corporations, owned in different proportions by the same shareholders, into a single entity.<sup>64</sup> Since a pro rata distribution of stock would not result in the desired percentage ownership, the consolidation could not be accomplished without a boot distribution.<sup>65</sup> Accordingly, the newly formed corporation, eventually named Omni, issued the taxpayer a promissory note.<sup>66</sup> Prior to the merger, the first corporation had an earned surplus of approximately \$102,000, while the second corporation had an earned surplus of \$38,000.<sup>67</sup> The Commissioner argued that the distribution of boot, to reflect the shareholder's greater entitlement, was taxable as a dividend.

The Eighth Circuit disagreed with the Commissioner, holding that the note did not have the effect of a distribution of a dividend under section 356(a)(2) and therefore was taxable at capital gain rates.<sup>68</sup> In determining that the boot distribution did not have the effect of a dividend, the *Wright* court applied the meaningful reduction analysis developed under section 302 in *Davis*.<sup>69</sup> Although there was no formal redemption, the court restructured the transaction as if there had been a redemption of the acquiring corporation's stock.<sup>70</sup> The court stated that the note "was issued by Omni [the acquiring corporation] in exchange for a portion of Omni stock that the taxpayer would have received if he had taken Omni stock entirely instead of receiving Omni stock and a note issued to him by Omni."<sup>71</sup> The court rejected the Government's argument that the boot should be considered as having been distributed prior to the reorganization.<sup>72</sup> Instead, the court held that the dividend equivalence rules provided in section 302 make sense only in relation to the acquiring corporation which remains in business after the reorganization is complete.<sup>73</sup>

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<sup>61</sup> *Id.* at 302. Both *Davis* and its progeny make it clear that business purpose is irrelevant in determining dividend equivalence under § 302. In short, the Commissioner should not scrutinize the transaction for its underlying rationale.

<sup>62</sup> *Id.* at 313.

<sup>63</sup> 482 F.2d 600 (8th Cir. 1973).

<sup>64</sup> *Id.* at 602.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* at 610.

<sup>69</sup> *Id.* at 607.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *Id.* at 607-08.

In applying section 302 to the boot distribution before it, the *Wright* court first examined the safe harbor provisions of section 302(b)(2).<sup>74</sup> The court determined that the hypothetical redemption did not meet the prescribed section 302(b)(2) mathematical qualifications.<sup>75</sup> Nevertheless, the court did find that the "redemption" resulted in a 23.3 percent reduction in the taxpayer's ownership in the surviving corporation.<sup>76</sup> On the basis of this reduction, the court concluded that the meaningful reduction test enunciated by the Supreme Court in *Davis* had been satisfied.<sup>77</sup> Since the hypothetical redemption did not have dividend equivalence under section 302(b)(1), the court held that the boot distribution did not have the effect of a distribution of a dividend under section 356(a)(2).<sup>78</sup>

The Service responded to the decision in *Wright* by issuing Revenue Ruling 75-83.<sup>79</sup> In this Ruling, the Service held that the application of section 302 principles to section 356(a)(2) requires a distribution of boot to be treated as a hypothetical redemption by the *acquired* corporation, not the *acquiring* corporation as the court held in *Wright*. The Revenue Ruling illustrated the Service's position with an example in which A owned 100 percent of the sixty outstanding shares of X corporation. X corporation then merged into Y corporation. Prior to the merger, Y corporation had forty shares of stock outstanding at a \$10 fair market value, of which B, C, D, and E each owned 25 percent. In return for all sixty shares of X corporation stock, A received thirty-five shares of Y corporation stock and a \$250 note. The Service took the position that in determining whether the boot distributed to A in exchange for his shares of X corporation stock had the effect of a distribution of a dividend, section 302 redemption principles should be applied as if X corporation, and not Y corporation, had redeemed a portion of its stock prior to the reorganization.<sup>80</sup> Viewing the distribution as a redemption by X corporation, it could not possibly result in a reduction of A's interest in X corporation since A was the sole shareholder of the acquired corporation. Thus, under the Service's approach, the distribution of boot to A would be taxable as ordinary income.<sup>81</sup>

An application of the *Wright* approach to the facts of Revenue Ruling 75-83 would, however, result in an entirely different conclusion. If A had received only Y corporation stock as consideration for a merger, A would have owned 60 percent of the 100 outstanding shares of Y corporation stock after the merger. Under the *Wright* court's view, the transaction would be

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<sup>74</sup> *Id.* at 608. Section 302(b)(2) establishes certain mathematical calculations which determine whether a distribution results in a "substantially disproportionate redemption of stock." See text at notes 53-54 *supra*.

<sup>75</sup> *Id.* at 608.

<sup>76</sup> *Id.* at 607.

<sup>77</sup> *Id.* at 609.

<sup>78</sup> *Id.* at 610.

<sup>79</sup> Rev. Rul. 75-83, 1975-1 C.B. 112.

<sup>80</sup> *Id.* at 113.

<sup>81</sup> Under I.R.C. § 316, corporate distributions are taxed as dividend income to the extent of the shareholder's pro rata share of earnings and profits.

restructured as if A had received sixty shares of Y corporation followed by a twenty-five share post-merger redemption. As a result of this hypothetical redemption, A's ownership percentage dropped from 60 percent to 48 percent, which would satisfy both the *Davis* meaningful reduction standard under section 302(b)(1) and the mathematical requirements of section 302(b)(2).<sup>82</sup> The Commissioner's refusal to follow the *Wright* decision leads ineluctably to the conclusion that any pro rata distribution of boot as part of a reorganization has the effect of a dividend distribution, since the Service has declined to examine changes in the shareholder's ownership of the acquiring corporation which may occur as a result of the merger.<sup>83</sup>

While it is clear that courts have abandoned the automatic dividend rule in favor of examining the facts and circumstances of each case, the proper application of section 302 standards to a section 356 boot distribution remains a source of considerable confusion. The differing approaches adopted by the Eighth Circuit in *Wright* and the Service in Revenue Ruling 75-83 reflect two opposing views of the use of section 302 "dividend equivalence" principles in deciding cases under section 356(a)(2). The Fifth Circuit in *Shimberg* rejected the Eighth Circuit's approach and adopted the view adhered to by the Service. In so doing, the Fifth Circuit has done little to eliminate the controversy which exists in this area of the tax law.

## II. THE SHIMBERG DECISION

The following discussion will first present a comparison of the *Wright* and *Shimberg* approaches to determining whether a distribution has the effect of a distribution of a dividend under section 356(a)(2). The section will then examine why the *Shimberg* approach is unjustified. Finally, the section will propose a legislative revision of section 356.

### A. Comparison of *Wright* and *Shimberg*

The district court in *Shimberg* refused to follow the Service's position in Revenue Ruling 75-83. Instead, the court based its conclusion that the boot distribution did not have the effect of a dividend on a comparison of the taxpayer's 66 percent pre-merger interest in LSC with his less than 1 percent post-merger interest in a large publicly held corporation.<sup>84</sup> The Fifth Circuit held that the district court had erred in utilizing a meaningful reduction standard, reasoning that such a standard would render section 356(a)(2) virtually meaningless.<sup>85</sup> The court maintained that a comparison of a shareholder's interest in the acquired corporation with his interest in the acquiring corporation would always reveal a marked shift in ownership percentage when a small company merges with a larger one. In this way, the *Shimberg* court rejected the *Wright* court's approach and effectively adopted the approach taken by the Service in Revenue Ruling 75-83.<sup>86</sup>

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<sup>82</sup> See text at notes 53-54 *supra*.

<sup>83</sup> See Levin, *supra* note 41, at 288-89.

<sup>84</sup> 415 F. Supp. at 836.

<sup>85</sup> *Id.* at 288.

<sup>86</sup> See text at notes 79-83.

The following illustration serves to demonstrate the difference between the Fifth Circuit's approach in *Shimberg* and the Eighth Circuit's approach in *Wright*. Prior to X corporation's merger with Y corporation, A owned all 100 shares of X corporation and B owned all 1,000 shares of Y corporation. As consideration for the transfer of his 100 shares in X corporation, A received sixty shares of Y stock and a \$40 boot. An examination of the transaction under the *Wright* court's approach would restructure the transaction to show receipt of 100 shares of Y corporation stock by A, followed by a forty share post-merger redemption by the *acquiring* corporation. The calculations which demonstrate the satisfaction of section 302 principles are as follows:

$$\begin{array}{l} \text{Post-merger ownership of Y} \\ \text{corporation:} \end{array} \quad \frac{100 \text{ shares (held by A)}}{1100 \text{ shares (outstanding)}} = 9.1\%$$

$$\begin{array}{l} \text{Post-merger ownership of} \\ \text{Y corporation after the} \\ \text{redemption:} \end{array} \quad \frac{60 \text{ shares (held by A)}}{1060 \text{ shares (outstanding)}} = 5.7\%$$

A) Section 302(b)(1):

$$\frac{.057}{.091} = .626$$

or a 37.4% reduction in A's ownership percentage from what he would have owned if he had not received the \$40 boot.

The 37.4 percent reduction certainly constitutes a meaningful reduction under *Davis*, and therefore section 302(b)(1) is satisfied and the distribution is entitled to capital gains treatment.

B) Section 302(b)(2):

$$80\% \text{ of } .91 = .073$$

Since .057 is less than .073, and since .057 is also much less than 50% of Y's total voting power, the mathematical requirements of section 302(b)(2) are also satisfied, and again the distribution is entitled to capital gains treatment.

In contrast, an examination of the above merger under the approach of the *Shimberg* court would restructure the transaction to show a pro rata distribution of boot by the *acquired* corporation as if no reorganization had taken place. In effect, corporation X distributed \$40 to its sole owner. If corporation X had sufficient earnings and profits at the time of the distribution, it would be characterized as a dividend and would be taxed as ordinary income.

As the above illustration demonstrates, the tax treatment of a boot distribution is dependent upon whether the determination of dividend effect is made with reference to the *acquired* or the *acquiring* corporation. As the *Shimberg* court recognized, the issue is obviously a complex one. Despite the court's statement to the contrary, however, the *Shimberg* decision signals a limited return to the automatic dividend rule.<sup>87</sup> In effect, this approach would deny capital gains treatment whenever the distribution of boot is made in proportion to the shareholder's stock ownership in the acquired corporation, and the acquired corporation has sufficient earnings and profits.

<sup>87</sup> 577 F.2d at 290.

### B. *An Evaluation of the Shimberg Approach*

It is submitted that the Fifth Circuit in *Shimberg* failed to justify its refusal to apply section 302 principles in determining the dividend effect of a boot distribution under section 356(a)(2). Furthermore, the approach taken by the *Wright* court represents the proper application of section 302 principles in the context of a reorganization. The failure of the *Shimberg* court's reasoning is five-fold. First, the court's interpretation assumes that Congress intended to "automatically" deny capital gains treatment whenever the distribution is pro rata. In the words of one commentator, "[i]f the Congress had intended such an automatic result . . . the language of section 356(a)(2) could and would have so stated."<sup>88</sup> Congress' use of the phrase "has the effect of the distribution of a dividend,"<sup>89</sup> implies that a more flexible analysis should be used and that each case should be considered on its own facts and circumstances.<sup>90</sup> This alternative interpretation is also supported by the fact that Congress adopted an explicit automatic rule in section 356(b)<sup>91</sup> and section 356(e),<sup>92</sup> and could have so provided when section 356(a)(2) was incorporated into the Internal Revenue Code of 1954.

Second, the Fifth Circuit fails to cite any authority for the proposition that section 302 standards should not be applicable to a section 356(a)(2) boot distribution.<sup>93</sup> The court's failure to find any support for this proposition is not surprising since courts have uniformly construed section 356 *in pari materia* with section 302 in determining the effect of a boot distribution.<sup>94</sup> The *Shimberg* court found the *Wright* decision distinguishable, noting that the facts of that case provided no opportunity for reshaping the transaction as a redemption since the corporations were owned and controlled by the same shareholders.<sup>95</sup> As was previously demonstrated, this argument is without merit.<sup>96</sup> If the transaction is viewed as a hypothetical post-merger redemption of shares in order to obtain the desired boot, it is entirely possible to ascertain whether the receipt of cash by Mr. Shimberg satisfied the dividend equivalence standards of section 302. In short, any dissimilarity between the facts of *Wright* and *Shimberg* simply does not support the Fifth Circuit's refusal to apply section 302 standards.

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<sup>88</sup> See SCOTT, *supra* note 43, at 49.

<sup>89</sup> I.R.C. § 356(a)(2) (emphasis added).

<sup>90</sup> 577 F.2d at 288.

<sup>91</sup> I.R.C. § 356(b).

<sup>92</sup> I.R.C. § 356(e).

<sup>93</sup> 577 F.2d at 288.

<sup>94</sup> See, e.g., *Hawkinson v. Commissioner*, 235 F.2d 747 (2d Cir. 1956); *Ross v. United States*, 173 F. Supp. 793 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959). See also *Kirschenbaum v. Commissioner*, 155 F.2d 23, 24 (2d Cir. 1946), in which Judge Learned Hand noted that "[w]hether the distribution of accumulated earnings 'has the effect of the distribution of a taxable dividend' is surely the same question as whether such a distribution is 'essentially equivalent to a dividend.'"

<sup>95</sup> 577 F.2d at 287.

<sup>96</sup> See text at notes 86-87 *supra*.

Third, the *Shimberg* court's reasoning fails to correspond with the legislative history of section 356.<sup>97</sup> The Committee Reports provide little support for the *Shimberg* court's holding that section 356(a)(2) requires a determination whether the distribution would have been taxed as a dividend in a transaction prior to the reorganization.<sup>98</sup> Section 356 was designed to prevent evasions in situations substantially similar to an example contained in the Committee Reports.<sup>99</sup> In this example, corporation A merged with corporation B, which was organized by the original shareholders for the purpose of bailing out earnings at capital gain rates. The stockholders in corporation A had the same interest before and after the merger. In contrast, if the transaction in *Shimberg* is restructured as a receipt of stock followed by a post-merger redemption by the acquiring corporation, it can be shown that the taxpayer substantially reduced his equity interest in MGIC.<sup>100</sup> In short, the distribution of boot in *Shimberg* was not the type of transaction Congress was attempting to prevent. Section 356 was intended to prevent a corporation from bail-

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<sup>97</sup> See H.R. REP. NO. 179, 68th Cong., 1st Sess. 14-15 (1924), reprinted in 1939-1 C.B. (Part 2), 241-42; S. REP. NO. 398, 68th Cong., 1st Sess. 15-16 (1924), reprinted in 1939-1 C.B. (Part 2), 266-67 [hereinafter cited as Committee Reports].

<sup>98</sup> *Id.* In *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945), the Supreme Court gave the following analysis of the Committee Reports: "The history of the legislation is not illuminating. . . . The reports of the Congressional Committee merely use the language of the section to explain it. . . . We are thrown back upon the legislative language for ascertaining the meaning which will best accord with the aims of the language, the practical administration of the law and relevant judicial construction." *Id.* at 290.

<sup>99</sup> See Committee Reports, *supra* note 97.

<sup>100</sup> The following analysis is condensed from calculations contained in the plaintiff's brief at pages 23-25:

The number of additional shares is obtained by dividing the amount of cash received by the taxpayer, \$417,449, by the market value of a share of MGIC stock on the date of closing, or \$58.35. The merger agreement called for a total exchange of MGIC voting common stock valued at \$3,750,000 and cash amounting to \$625,000 for all the outstanding shares of LSC. At the time of the merger, taxpayer received, in exchange for his LSC stock, 21,461 shares of MGIC stock and \$417,449 in cash. Taxpayer had no interest at the time of the merger in an additional 21,461 shares placed in escrow, such interest being entirely a future interest dependent on the post-merger earnings of the LSC business. Assuming that taxpayer's cash consideration had been received in stock, he would have obtained an additional 7,154 shares of MGIC stock ( $\$417,499 \div \$58.35$ ) for a total of 28,615 (21,461 plus 7,154) shares. Prior to the merger, 6,204,448 shares of MGIC stock were issued and outstanding. An additional 32,132 shares were issued to the LSC stockholders at the time of the merger, for a total of 6,236,580 shares issued and outstanding. Had the \$625,000 cash consideration been exchanged as stock in the merger, 10,711 more shares would have been issued to the LSC stockholders ( $\$625,000 \div \$58.35$ ) for a total of 6,247,291 MGIC shares issued and outstanding. Assuming an "all stock" merger and a post-closing redemption of that number of the taxpayer's shares equivalent to the cash he already received, all as contemplated by *Wright*, the taxpayer suffered a substantially disproportionate redemption

ing out retained earnings when there is no meaningful reduction in the shareholders' equity interest in the corporation.

Fourth, the court's reasoning is internally inconsistent. In reaching its decision, the *Shimberg* court reasoned that the distribution was merely a method by which a continuing business enterprise could obtain favorable tax treatment for a pro rata transfer of earnings and profits.<sup>101</sup> The court attempted to justify its conclusion through the use of the following syllogism:

If a pro rata distribution of profits from a continuing corporation is a dividend and a corporate reorganization is a "continuance of the proprietary interests in the continuing enterprise under modified corporate form," it follows that a pro rata distribution of "boot" to shareholders of one of the participating corporations must certainly have "the effect of the distribution of a dividend" within the meaning of § 356(a)(2).<sup>102</sup>

The court's analysis is circular, since its conclusion appears as its major premise; the court assumes that the boot was a "pro rata distribution of profits," which is exactly what it set out to prove. Since the conclusion results by defini-

within the meaning of Section 302(b)(2). The calculations demonstrating this are as follows:

(a) Taxpayer's % Ownership After the Merger:

$$\begin{array}{r} 28,615 \\ \hline 6,247,291 \end{array} = \frac{\text{MGIC shares owned by the taxpayer} \\ \text{(21,461) + (7,154) equivalent to cash}}{\text{issued and outstanding MGIC} \\ \text{stock (6,236,580) plus 10,711} \\ \text{shares equivalent to cash}} \\ = 0.458\%$$

(b) Taxpayer's % Ownership After the Merger and After a Redemption on His Stock Equivalent to Cash Received in the Merger:

$$\begin{array}{r} 21,461 \\ \hline 6,236,580 \end{array} = \frac{\text{MGIC shares owned by taxpayer} \\ \text{(28,615) less 7,154 shares} \\ \text{equivalent to cash}}{\text{issued and outstanding MGIC} \\ \text{stock (6,247,291) less 10,711} \\ \text{shares equivalent to cash}} \\ = 0.3441\%$$

(c) 80% of Taxpayer's Ownership Position Prior to the Redemption:

$$(0.80 \times 0.00458) = 0.366\%$$

(d) Taxpayer's Subsequent Ownership Position:

0.3441% is less than 0.366% (80% of his prior ownership position), and, furthermore, is less than 50% of MGIC's total voting power.

<sup>101</sup> 577 F.2d at 288.

<sup>102</sup> *Id.*

tion, the court's reasoning provides little support for its position that any pro rata distribution incident to a reorganization should invariably be treated as a dividend to the extent of earnings and profits.

Finally, the *Shimberg* court's determination that the tax treatment of a dividend should be measured by examining the earnings and profits of the acquired corporation is inconsistent with the Government's litigating position in *Wright* and the plain language of section 356(a)(2).<sup>103</sup> In *Wright*, the court stated:

We agree with the Commissioner that "it is not material whether the distribution is actually made by the corporation entering the reorganization or by the corporation resulting from the reorganization." Courts and the Commissioner have said that it is *irrelevant* whether the earnings and profits were distributed before or after consolidation.<sup>104</sup>

The court in *Wright* held that the boot distribution was not a dividend and did not examine the earnings and profits of either corporation.<sup>105</sup> In Revenue Ruling 75-83 the Service itself recognized that the express statutory language of section 356(a)(2) requires that "the *amount* of the dividend is measured by reference to the earnings and profits of the transferor."<sup>106</sup> Accordingly, the determination whether a distribution of boot has the effect of a dividend should be made *prior* to any examination of earnings and profits.

As a consequence of the above five considerations, it is suggested that a court faced with a situation similar to the one in *Shimberg* should restructure the transaction as a hypothetical receipt of stock followed by a post-merger redemption by the acquired corporation. In making this inquiry, the criteria developed for use under section 302 should be applied. The court should treat the issue as an ultimate question of fact to be resolved through an examination of the entire transaction.<sup>107</sup> Despite the *Shimberg* court's holding to the contrary, the court should examine not only the pro rata nature of the distribution, but also examine changes in the taxpayer's control of the post-merger corporation.

### C. Proposed Congressional Revision of Section 356

The determination of dividend effect under section 356(a)(2) remains, as before *Shimberg*, a source of considerable confusion in the tax law. As a result, a congressional clarification on the proper tax treatment of boot received in the context of a reorganization would serve to reduce the problems which arise in this area. A suggested possible revision of section 356 is as follows:

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<sup>103</sup> *Id.* at 289.

<sup>104</sup> 482 F.2d at 607 (emphasis added).

<sup>105</sup> *Id.*

<sup>106</sup> 1975-1 C.B. 112.

<sup>107</sup> See Treas. Reg. § 1.302-2(b). See also *Wright*, 482 F.2d at 605, and *Shimberg*, 415 F. Supp. at 836 (district court opinion).



Eliminate the phrase "has the effect of the distribution of a dividend" from paragraph (2) and substitute the "meaningful reduction" standard enunciated in *Davis*.

Add the following paragraph:

(3) DEFINITION—For purposes of paragraph (2) a distribution of money or property shall be treated as having been made by the acquiring corporation.

Application of the *Davis* meaningful reduction analysis would provide the courts with a clear guideline for applying the principles of section 302 in a predictable and consistent manner. Furthermore, the proposed definitional subsection would allow the Congress to clearly indicate that the approach adopted by the Eighth Circuit in *Wright* is more consistent with the fulfillment of the purpose behind section 356(a)(2).

### CONCLUSION

In *Shimberg*, the Fifth Circuit held that a pro rata distribution of cash pursuant to a corporate reorganization will be restructured as a dividend distribution made by the acquired corporation prior to merger. In so doing, the Fifth Circuit ignored the express language of the statute, its legislative history, and the clear weight of authority. It is submitted that the *Shimberg* court should have applied the alternative analysis utilized by the Eighth Circuit in *Wright v. United States*. If it had done so, the distribution of boot to the taxpayer would not have been taxable as a dividend, but as a capital gain.

TRENHOLME J. GRIFFIN